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IN THE

Supreme Court of the United States

October Term, 1973

No. 73-1693

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

Opinions Below

The findings of fact and opinion of the Tax Court which were submitted to and reviewed by the entire Tax Court with no dissenting opinions filed (App. A at 1A-18A) are reported at 58 T.C. 679. The opinion of the Court of Appeals, to which no dissenting opinion was filed, (App. B at 19A-35A including an order amending the opinion), is reported at 488 F. 2d 1101.

Question Presented

Whether the reserve held by The Mutual Benefit Life Insurance Company pursuant to Section 17:34-22.1[1] of the

1. Now Section 17B:19-3 of the New Jersey Statutes.

New Jersey Statutes, for payments under settlement options involving life contingencies, in outstanding unmatured policies of life insurance, was a life insurance reserve within the provisions of Section 801(b) of the Internal Revenue Code of 1954.[2]

Statement of the Case

Although the basic facts in this case are not in dispute, they are complex and complicated. Therefore, this Statement of the Case is included to more completely and accurately present the facts than the summary contained in the Petition.

The Mutual Benefit Life Insurance Company (herein "Mutual Benefit"), a mutual life insurance company as defined in Section 801(a), is a New Jersey corporation. Its principal place of business is in Newark, New Jersey, and it is subject to the provisions of the New Jersey laws applicable to the operations of mutual life insurance companies and to regulations promulgated pursuant to such laws by the State of New Jersey Department of Banking and Insurance (herein the "State Insurance Department").

From 1908 through September 16, 1945, the policies of life insurance issued by Mutual Benefit (herein the "P-Policies") provided for optional modes of settlement upon the maturity of the policy. Included as one of the settlement options was the right to payment of a specified amount for the life of the beneficiary or beneficiaries but not less than for a period certain (herein the "Settlement Option"). A schedule in the policy set forth the exact dollar amount of each installment to be paid in lieu of each $1,000 of face amount of the policy. The amount of the payment varied depending on (i) the period certain, (ii) the frequency of payment, (iii) the age or ages of the beneficiary or beneficiaries and (iv) in some policies the sex of the beneficiary or beneficiaries. Under the terms of the policy, the install-

2. All Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

ments payable were guaranteed and Mutual Benefit was bound to pay such amount upon the maturity of a P-Policy.

During the time that the P-Policies were being issued and continuing thereafter, there was a substantial lengthening of the life expectancy at all ages. At the time that the P-Policies were issued, the bases adopted for determining the reserves were such that the basic policy reserves for the P-Policies would be sufficient to cover Mutual Benefit's obligation to provide all benefits contained in the P-Policies, including the Settlement Option. However, as a result of the lengthening life expectancy, it became apparent that the basic policy reserve established for the P-Policies would be inadequate to provide for Mutual Benefit's liability under the P-Policies in the event that the insured or the beneficiary elected the Settlement Option because the value of the Settlement Option exceeded the face amount of the policy.

The decrease in the rate of mortality did not increase the reserves being held for the P-Policies since the excess in premiums received during the life of these policies was either distributed to the policyholder in the form of dividends or became a part of Mutual Benefit's surplus. The income of Mutual Benefit from the P-Policies increased since it received premiums for a greater number of years.

Mutual Benefit determined in 1945-1946 that its reserves for all settlement option payments involving life contingencies should be computed on the basis of the 1937 Standard Annuity Mortality Table (herein the "1937 Annuity Table"). This was accomplished (i) with respect to settlement options involving life contingencies available in policies to be thereafter issued, by a policy change on September 16, 1945 which used the 1937 Annuity Table in constructing the schedules of installment payments contained therein; (ii) with respect to such settlement options contained in matured P-Policies, by a strengthening of the reserves relating thereto by adopting the 1937 Annuity Table; and (iii) with respect to the Settlement Option contained in

the P-Policies not yet matured, by the establishment of the challenged reserve, as of December 31, 1946, pursuant to Section 17:34-22.1 of the New Jersey Statutes, which was computed on the basis of the 1937 Annuity Table as hereafter described (herein the "Additional Reserve").

The establishment of the Additional Reserve provided a reserve for Mutual Benefit's increased liability to future beneficiaries under the outstanding P-Policies and enabled Mutual Benefit to assess the cost of the additional liability for the Settlement Option to the P-Policyholders by reducing the dividends to be paid.

The actuarial computation involving the 1937 Annuity Table took into account (a) the projected rate of election of the Settlement Option, (b) the age and sex of beneficiaries, (c) the amount of the policy proceeds which would become subject to election, and (d) the future date on which such elections would become effective. It was assumed that the amount which would be required in each year in the future, which was designated by Mutual Benefit as the "strain", would remain at a constant percentage of policy proceeds arising from all death claims and endowment maturities under the P-Policies. This percentage was obtained by dividing the additional amounts needed in past years to provide for such additional liability on the basis of the 1937 Annuity Table, adjusted, and an assumed rate of interest of 2¾%, by the policy proceeds arising from all death claims and endowment maturities for such past years.

The "strain" thus computed was discounted for interest at 3% per annum, which resulted in the estimate that approximately $37,000,000 would be required for the Additional Reserve for the Settlement Option costs as of December 31, 1946. Since the charge of the full amount to surplus in that year would result in a corresponding reduction in the dividends payable to its policyholders, Mutual Benefit elected not to set up the full amount of its estimate. Instead amounts were set up each year thereafter until 1953 on

specific identifiable groups of policies issued between two dates antedating 1946. On December 31, 1953, the Additional Reserve amounted to $21,404,000 and covered all the P-Policies. This amount remained fairly constant for the next three years.

In computing the Additional Reserve which would be required as of January 1, 1957, Mutual Benefit took into account its "strain" experience for the years 1952 through 1956, both inclusive. It determined the "strain" ratios for each such year by dividing the aggregate of initial reserves established on the basis of the 1937 Annuity Table, adjusted, and an assumed rate of interest of 2¾%, less proceeds applied pursuant to Settlement Option elections, by the total proceeds maturing as death claims and endowments in each of these past years. The average "strain" ratio for this five-year period was determined to be .02375.

There were over 400,000 P-Policies involving in excess of $1,500,000,000 of insurance in effect in 1957 when the computation was made. The proceeds from P-Policies maturing during the period 1952-1956 amounted to approximately $200,000,000 with an average policy size of $9,000 to $10,000, so that approximately 20,000 policies were involved in determining the "strain" ratio.

The 1952-1956 average "strain" was then applied to the expected death claims and endowment maturities for each year beginning with 1957 and ending with 2031 (the year in which it was expected that the youngest P-Policyholder would reach age 96, at which age all P Policies matured as endowments). Future death claims and endowment maturities were obtained by the use of Mutual Benefit's mortality experience for 1952 through 1956 and a lapse rate of 1.75% which was also arrived at on the basis of Mutual Benefit's experience.

Upon the basis of these calculations, Mutual Benefit determined the amount which would be required to meet the "strain" for each of the years 1957 through 2031. These

amounts were then discounted to January 1, 1957, on the basis of an assumed rate of interest of 3%. In accordance with this procedure, the Additional Reserve required as of January 1, 1957, was determined to be $18,586,369. Mutual Benefit agreed with the State Insurance Department to review the method of computation every five years.

Since the actual "strain" for 1957 and 1958 approximated the projected "strain" under the 1957 computation, Mutual Benefit computed the Additional Reserve at December 31, 1957, 1958, 1959 and 1960 by increasing it by an assumed interest rate of 3% and reducing it by the actual "strain" for each year. This proposal was submitted to, and approved by, the State Insurance Department.

The projected "strain" and actual "strain" were, as follows:

Year	Projected "Strain"	Actual "Strain"
1957	$1,015,729	$999,065
1958	1,055,444	907,215
1959	1,077,265	916,560
1960	1,093,449	841,529

The Additional Reserve was set aside and reported in Mutual Benefit's Annual Statements filed with the State Insurance Department for the calendar years 1957, 1958, 1959 and 1960, and in the "Certificate of Valuation of Policies" issued by the State Insurance Department for each of those years.

Mutual Benefit took the Additional Reserve into account in computing its federal income tax for 1958, 1959 and 1960. The Petitioner asserted deficiencies of $295,077.97, $296,495.14 and $296,297.16, respectively, for those years, alleging that the Additional Reserve was not a "life insurance reserve" within the meaning of Section 801(b) (App. D at 37A, 38A).

ARGUMENT

I.

Certiorari should not be granted to review a decision which is not in conflict with that of other Courts of Appeals and which involves a particular factual situation.

(1) The decision of the Court of Appeals is not in conflict with that of the Courts of Appeals of any other circuit or the Court of Claims. In this case, which was reviewed by all sixteen judges of the Tax Court and considered by a three judge panel at the Court of Appeals, there is not even a dissenting opinion.

The Petitioner has argued that the decision below is in conflict with certain general principles enunciated by this Court and those of the Courts of Appeals. These arguments were advanced below on the merits and were rejected by either the Tax Court or the Court of Appeals or both. The cases cited by the Petitioner as in conflict with this case are distinguishable and therefore not relevant to the present case and are so distinguished in Part II of this Argument which is concerned with the alleged conflict of decisions.

(2) The decision in this case is limited to the factual situation presented in this case. The Court of Appeals stated that the Petitioner asserted three reasons why the Additional Reserve did not qualify under Section 801(b), *viz.* (i) that the reserve was not required by law; (ii) that the reserve was improperly computed; and (iii) that the reserve constituted a "deficiency reserve".

The question of whether the reserve was "required by law" was determined with particular reference to Section 17:34-22.1 of the New Jersey Statutes which was applicable to Mutual Benefit. This statute is applicable only to New Jersey life insurance companies. The Petitioner has indicated that the Internal Revenue Service has advised that of $59,700,000 of tax presently pending before it on this

type of reserve, only $11,000,000 is in dispute with insurance companies which can sue in the Third Circuit. Of the five companies listed as within this category only Mutual Benefit and Prudential Life Insurance Company are New Jersey companies which would be subject to the provisions of Section 17:34-22.1 of the New Jersey Statutes. We are advised by the State Insurance Department that these are the only two New Jersey companies which have established reserves under Section 17:34-22.1 of the New Jersey Statutes.

The second issue, whether the method used in computing the Additional Reserve was proper, was the subject of more than fifty pages of testimony and supported by expert testimony. On the basis of this evidence the Tax Court made findings of fact as to the computation made by Mutual Benefit. It is submitted that the computational procedures used by Mutual Benefit were unique to Mutual Benefit and that the procedures of any other company would have to be considered separately and in similar detail.

The third issue, that the Additional Reserve was a "deficiency reserve", was withdrawn from consideration by the Tax Court by the Petitioner and found to be without merit by the Court of Appeals. The Court of Appeals correctly held that this argument was not applicable to the facts of this case.

The Court of Appeals expressly recognized the particularity of the factual situation presented: "We have trod a narrow path charted by the specific factual situation present here and our opinion should be so understood" (App. B at 34A). The only case found citing the present case, *Delta Life Insurance Co.* v. *United States*, 363 F. Supp. 401 (E.D. La. 1973) (which cited the Tax Court decision), distinguished this case on the grounds that the New Jersey statute here involved was not applicable to the Louisiana insurance company before that court.

II.

There Is No Conflict of Decisions.

The Petitioner has asserted that the decision below conflicts with rulings of this Court and those of the Courts of Appeals in three general areas: (i) that life insurance reserves must be derived only from premiums; (ii) that the Additional Reserve does not qualify under Section 801(b) since it was established merely to cover a contingent obligation to issue an annuity contract; and (iii) that the decision below expands the definition of life insurance reserves long established by this Court.

A. Reserves need not be accumulated from premiums to be life insurance reserves within the provisions of Section 801(b).

The principal thrust of the Petitioner's argument in his Petition is that the Additional Reserve fails to meet the requirements of Section 801(b) since the Additional Reserve was not derived from premiums. Section 801(b) contains no requirement that reserves be derived from premiums. A recent publication, in considering the definition of insurance reserves for purposes of the provisions of the Internal Revenue Code, recognized that the emphasis on premiums is not contained in the current statute. Walker, Levy and Knickerbocker, 245 T.M., Life Insurance Companies—Definition and Accounting at A-3 (1970).

Although it is usual, and certainly the hope of the insurance company, that premiums on its policy will provide the required reserves, a change of circumstance may require an increase in the reserve originally set aside. This procedure is called "strengthening" and such increase results in a charge against the surplus of the company. In advancing his argument the Petitioner has chosen to ignore the fact that the establishment of the Additional Reserve was a strengthening of the reserves under the P-Policies. Even the Petitioner has recognized that in a strengthening re-

serves are established out of surplus. Rev. Rul. 69-444, 1969-2 Cum. Bull. 145 stated:

> At the end of 1966 the taxpayer, in order to provide for the new contractual obligation, established out of surplus a reserve in an amount equal to the present value of the future unaccrued obligation . . . .

See also Rev. Rul. 65-233, 1965-2 Cum. Bull. 228; *United Life and Accident Insurance Co.* v. *United States*, 329 F. Supp. 765, 777 (D.N.H. 1971).

There exists in actuarial texts two definitions of reserves, the so-called "prospective" and "retrospective." The Petitioner has relied on the "retrospective" definition of life insurance reserves in which a reserve is defined as "the accumulation at the assumed rate of interest of the net premiums received, less the death claims provided for by the mortality table." J. MacLean, LIFE INSURANCE at 114 (9th Ed. 1962). The cases cited by the Petitioner in support of his position all pre-date the Revenue Act of 1942, ch. 619, § 201, 56 Stat. 867, when the present "prospective" definition of life insurance reserves was adopted. Under the prospective definition, reserves are defined as an amount equal to the "difference between the present value of future benefits and the present value of future net premiums". D. McGill, LIFE INSURANCE, at 218 (Rev. Ed. 1967); *see* D. McGill, *supra*, at 221 and D. Gregg, LIFE AND HEALTH INSURANCE HANDBOOK at 151 (1964); see also Rev. Rul. 70-192, 1970-1 Cum. Bull. 153. Only this "prospective" definition is contemplated and provided by Section 801(b) and Treas. Reg. § 1.801-4(a) (App. D at 41A). Only this concept is consistent with various operative provisions of the Internal Revenue Code, such as Section 806(b) and Section 810(d) relating to the strengthening of reserves. Only with the prospective definition would Section 801(b)(4) relating to "deficiency reserves" be either necessary or meaningful.

Since Section 818(a) (App. D at 40A) contemplates that computations by insurance companies for federal income tax purposes will be consistent with that required for the annual statement of the insurance company, i.e., under state law, it is noted that the state laws on reserves express reserve requirements in terms of the prospective definition. See McGill, *supra*, at 230; e.g., Conn. Gen. Stat. § 38-130; N.J. Stat. § 17B:19-2; N.Y. Ins. Law § 73 (McKinney's, 1962).

In stating that a reserve is "made up of the sum of net premiums . . ." (Petition at 11) the Petitioner is asserting that a reserve is a "fund" accumulated from a particular source, not merely an amount represented as a liability on the insurance company's balance sheet. As noted by MacLean (Petitioner's App. E at A 48):

> The reserve is carried as a liability in the financial statements of life-insurance companies since it represents an obligation to the policyholders. The term "fund" does not refer to any specific allocation of assets to offset this particular liability.

Premiums are in fact a source of assets which are available with other assets to back up these reserve liabilities. However, the Petitioner asserts that "[i]n holding that a reserve not derived from net premiums established by a life insurance company to meet a contingent contractual liability is a life insurance reserve, the decision below conflicts with this Court's rulings in *Helvering* v. *Inter-Mountain Life Ins. Co.*, 294 U.S. 686 and *Helvering* v. *Illinois Ins. Co.* [sic], 299 U.S. 88. See also *Continental Assur. Co.* v. *United Siates*, 8 F. Supp. 474 (Ct. Cl.)" (Petition at 6).

These cases do not require that a reserve be a fund accumulated from premiums. In each of these decisions

the subject reserve failed to qualify because the obligations involved contained no life contingency, and not by reason of the reserve being derived from a source other than premiums. No such requirement can be found in Section 801(b). Moreover, such a construction ignores the realities of life insurance company operations as noted in the foregoing quote from MacLean. Therefore, since a reserve is not, and never has been, an accumulation fund in insurance company practice, it is submitted that the words "accumulated . . . out of premiums" as used in *Inter-Mountain Life* at 690, are illustrative, rather than mandatory. In effect, the Additional Reserve was derived from premiums since the P-Policy dividends were reduced from 1948 through 1962 in order to restore the surplus used in establishing the Additional Reserve.

Thus, since the reserves in each of the foregoing decisions, unlike the Additional Reserve, involved no life contingencies, the amount of the related liabilities was at all times determinable without the use of any mortality assumptions.

On the basis of the above decisions, the Petitioner further argues that "Congress used the phrase 'life insurance reserves' as 'words of art' to describe a particular kind of reserve, namely, one designed to provide an amount sufficient to pay either the face amount of the policy or its cash surrender value" (Petition at 15). Such a limitation has not been imposed by the courts. See *Commissioner* v. *Monarch Life Insurance Co.*, 114 F. 2d 314 (1st Cir. 1940), where a reserve for disability waiver of premium benefits was held to qualify as a life insurance reserve.

One can only conclude that the decision below is not in conflict with the cited cases and that there is no requirement that reserves under Section 801(b) come only from premiums.

B. The Additional Reserve was established to cover a life contingency in a life insurance contract.

The Petitioner has asserted that since the Additional Reserve was allegedly established with respect to a contingent obligation to issue annuity contracts, this decision is in conflict with *New York Life Insurance Company* v. *Edwards*, 271 U.S. 109 (1926) and *Jefferson Standard Life Insurance Company* v. *United States*, 408 F. 2d 842, (4th Cir. 1969), *cert. den.* 396 U.S. 828 (1969) (Petition at 7). Such is not the case. It is well established that the obligation of an insurance company under settlement options contained in a life insurance contract is just as much an obligation of the company under the contract as is the obligation to pay a lump sum amount. The provisions of the P-Policies, court decisions, statutory law, and administrative rulings demonstrate that the obligation to make payments under a settlement option does not constitute constructive receipt of the proceeds of the life insurance contract and the purchase of an annuity, but is a continuation of the policy containing such option.

This principle is set forth in *The Mutual Benefit Life Insurance Company* v. *Herold*, 198 Fed. 199, 212 (D.N.J. 1912), *aff'd*, 201 Fed. 918 (3rd Cir 1913), *cert. den.* 231 U.S. 755 (1913), where the court stated:

> Notwithstanding the policyholder has died, there still remain unpaid under the policy certain installments not presently due but which will mature from time to time in the future. *These are as much policy obligations as they would have been if payable in one sum immediately upon the death of the insured.* They have a value, and that value must be estimated, and, when estimated, adequate provision made for their payment as they mature which can only be done by the establishment of a suitable reserve (Emphasis added).

See also *Gram* v. *Mutual Life Insurance Company of New York*, 300 N.Y. 375, 91 N.E. 2d 307 (1950); *Hall* v. *Mutual*

Life Insurance Company of New York, 282 A.D. 203, 122 N.Y.S. 2d 239 (1953); Couch on Insurance 2d § 81:4.

Neither *New York Life Insurance* nor *Jefferson Standard* is applicable to the present situation since the obligations considered there did not arise under a life insurance contract but were obligations arising from an employment contract and an employee benefit plan, respectively.

By stating that "these rulings of the Court firmly repudiate the notion that an insurance reserve can be established with respect to anticipated losses" (Petition at 13), the Petitioner not only misinterprets these decisions but also fails to understand the very nature of life insurance. Every life insurance policy's purpose is to insure for an anticipatory loss.

The Petitioner cites *McCoach* v. *Insurance Company of North America*, 244 U.S. 585 (1917); *United States* v. *Boston Insurance Company*, 269 U.S. 197 (1925); and *New York Life Insurance Company* v. *Edwards* 271 U.S. 109 (1926), as authority for the statement that "reserves established to meet anticipatory losses or expenditures were not 'reserve funds' for purposes of the income tax statutes even though they were required by state law" (Petition at 12). Both *Insurance Company of North America* and *Boston Insurance Company* involved reserves for accrued but unpaid losses payable by casualty insurance companies. *New York Life Insurance Company* involved a reserve for unreported losses on deaths which had already occurred. The quoted portion from *New York Life Insurance Company* that "[t]he item under consideration represented a liability and not something reserved from premiums to meet policy obligations" warrants some comment. As noted above, a life insurance reserve is a liability for unaccrued claims on the insurance company's financial statements as required by state insurance laws. Accordingly, the quoted reference to "liability" can only be construed to mean a liability other than a future unaccrued claim arising from a policy obligation.

Since the Additional Reserve was set aside to mature or liquidate, by payment, future unaccrued claims involving life contingencies arising from life insurance policies (not accrued claims without life contingencies as in the cases cited by the Petitioner), the Additional Reserve is properly a life insurance reserve under Section 801(b) and is not in conflict with the cited cases.

C. The decision below does not expand the definition of life insurance reserves established by this Court.

The Petitioner has further asserted that the "expansive scope" of the decision in this case cannot be "reconciled" with the decision of this Court in *McCoach* v. *Insurance Company of North America*, 244 U.S. 585 (1917); *United States* v. *Boston Insurance Company*, 269 U.S. 197 (1925); and *New York Life Insurance Company* v. *Edwards*, 271 U.S. 109 (1926) (Petition at 6, 7). The Petitioner has not indicated in what manner these cases are irreconcilable. A review of the cited cases indicates their irrelevance. None of these cases is concerned with Section 801(b) and all predate the adoption of the current definition of reserves in 1942. Both *Insurance Company of North America* and *Boston Insurance Company*, which merely followed the holding in *Insurance Company of North America*, were concerned with reserves for accrued claims (unreported losses on deaths which had already occurred), not unaccrued claims involving life contingencies, as present in this case.

New York Life Insurance Company is equally not in conflict with the decision involved here. There three separate alleged reserves were considered by this Court. None of the reserves remotely resembles the Additional Reserve and none of the reasons advanced by this Court as to why each reserve did not qualify is applicable here. One of the reserves related to accrued losses, another dealt with obligations under an employment agreement with sales agents and the third had not been considered by the state insurance department as a reserve.

The assertion that the present decision is in conflict with the cited cases is not sustained by a reading of the cases.

III.

Affirmance of the decision of the Tax Court that the Additional Reserve is a life insurance reserve within the provisions of Section 801(b) was proper.

The definition of "life insurance reserves" is set forth in Section 801(b). Although the Petitioner has implied that the Court of Appeals decision was based on factors other than the express requirements of Section 801(b) (Petition at 6), the Court expressly stated that such was not the fact (App. B at 28A). In finding that the Additional Reserve conforms to the requirements of the Internal Revenue Code, the Court of Appeals considered specifically the three arguments presented to it by the Petitioner. These were that (1) the Additional Reserve was established voluntarily and, therefore, was not required by law, (2) life insurance reserves must be computed solely on the basis of a recognized mortality table and assumed rate of interest, and (3) the definition of "deficieney reserves" would include the Additional Reserve (App. B at 26A).

1. The term "required by law" is intended to refer to the character of the life insurance reserves and particularly to their "inviolability" under applicable law. Therefore, a life insurance reserve may not be used for any purpose or represent a liability for any exposure other than the life insurance claims for which it was set aside and may not be reduced except with the approval of the applicable state authorities. *Maryland Casualty Company* v. *United States*, 251 U.S. 342 (1920); *General Life Insurance Co.* v. *Commissioner*, 137 F.2d 185 (5th Cir. 1943); *Lamana-Panno-Fallo Industrial Insurance Co.* v. *Commissioner*, 127 F.2d 56 (5th Cir. 1942); *Commissioner* v. *Monarch Life Insurance Co.*, 114 F.2d 314 (1st Cir. 1940).

The Additional Reserve was specifically recognized and authorized by Section 17:34-22.1 of the New Jersey Statutes. As provided in that statute, the basis on which the Additional Reserve was computed could not be changed or modified to a basis producing a smaller reserve without the prior approval of the State Insurance Department. It was proven at trial that the Additional Reserve was established, held and set aside not only prior to 1958, 1959 and 1960, the tax years in question, but also prior to the enactment of the applicable sections of the Internal Revenue Code by the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (herein the "1959 Act"). Therefore, at all times before the Court the Additional Reserve was set aside solely for the fulfillment of obligations involving life contingencies under the P-Policies as required by the specific provisions of the New Jersey Statutes.

The term "required" as used in Section 801(b)(2) does not preclude reserves which are voluntarily established by a life insurance company. Such a restrictive construction would be inconsistent with the recognition given by the federal income tax law to life insurance reserves in excess of the legal minimum standards of valuation in state law and with the provisions which have been enacted concerning the strengthening of reserves. Proposed Treas. Reg. § 1.801-5(b), 25 Fed. Reg. 7986 (App. D at 48A, 49A), would have recognized only that amount of the reserves as calculated according to the legal minimum standards. This limitation was deleted in the regulation as adopted. Treas. Reg. § 1.801-5(b) (App. D at 44A).

Legislative recognition that reserves in excess of legal minimum standards are "required by law" appears in H.R. Rep. No. 34, 86th Cong., 1st Sess. (1959), reprinted in 1959-2 Cum. Bull. 736, 751, and in S. Rep. No. 291, 86th Cong., 1st Sess. (1959), reprinted in 1959-2 Cum. Bull. 770, 801, where, in discussing "deficiency reserves" the present value of future net premiums is determined

according to "the standard adopted by the insurer, the minimum standard required by State Law, or otherwise...."

The provisions in the 1959 Act concerning strengthening of reserves demonstrate Congressional awareness that increases in, and additions to, life insurance reserves are, in the first instance, at the option of the insurance company. See Sections 806(b) and 810(d); H.R. Rep. No. 34, *supra*, at 749; S. Rep. No. 291, *supra*, at 794. Even the Commissioner has recognized that the initiative in establishing life insurance reserves is with the insurance company. Rev. Rul. 65-233, 1965-2 Cum. Bull. 228, provides that for purposes of Sections 806(b) and 810(d), a reserve strengthening is effective in the taxable year that the company has taken all necessary action even though the annual statement reporting such strengthening is submitted to the appropriate state regulatory authority and approved the next year.

2. Both courts below found that the Additional Reserve was computed or estimated on the basis of an assumed rate of interest of 3% to provide, on maturity of all P-Policies, initial reserves for the Settlement Option on the basis of a recognized mortality table, that is, the 1937 Annuity Table, adjusted, and an assumed rate of interest of 2¾% (Apps. A and B).

The Petitioner cites Rev. Rul. 67-435, 1967-2 Cum. Bull. 232; Rev. Rul. 68-441, 1968-2 Cum. Bull. 293; and Rev. Rul. 69-302, 1969-1 Cum. Bull. 186, as authority for the statement that "life insurance reserves may be based only upon the contingencies of mortality and an assumed rate of interest and that a reserve which embodies other contingencies does not meet the statutory requirements" (Petition at 18). At no point in any of these rulings is it stated or implied that factors in addition to a recognized mortality table and assumed rates of interest could not be considered in the computation or estimation of a reserve set aside exclusively to provide for life insurance benefits, as is the case with the Additional Reserve. To the contrary, the wording of Sec-

tion 801(b)(1)(A) and decisional law recognizes and contemplates the propriety of the use of factors other than the assumed rate of interest and the mortality table. Section 801(b) specifically states that a life insurance reserve "means . . . amounts which are computed or *estimated* . . ." (Emphasis added.) See *Delta Life Insurance Co.* v. *United States, supra.* This Court, in *Maryland Casualty Company* v. *United States,* 251 U.S. 342, 350 (1920) stated "reserves" mean ". . . a sum of money, variously computed or estimated. . . ." See also *Ocean Accident & Guarantee Corp., Ltd.* v. *Commissioner,* 47 F. 2d 582 (2d Cir. 1931); *Pacific Mutual Life Insurance Company,* 48 T. C. 118 (1967), *rev'd on other issue* 413 F.2d 55 (9th Cir. 1969).

These decisions hold that estimates, based on past experience, are not only acceptable but necessary in the computation of a life insurance reserve recognized for federal income tax purposes. If the challenged elements in Mutual Benefit's computation had not been used, the Additional Reserve would have been four or five times greater. As noted, the accuracy of the computation and projections made by Mutual Benefit was ultimately confirmed by the actual results for the years in issue (*Supra,* at 6).

The legislative history of the 1959 Act also contemplates a more realistic computation than that argued by the Petitioner. Both H. R. Rep. No. 34, *supra,* at 756, and S. Rep. 291, *supra,* at 808, in discussing reserve strengthening under Section 806(b) state that a strengthening can occur "by reason of a change in mortality or interest assumptions, *or otherwise*" (Emphasis added). The Treasury Regulations have adopted this construction. See Treas. Reg. § 1.806-4(b), *Example 1.*

Accordingly, based on the findings of facts of the Tax Court, the Court of Appeals properly affirmed the determination that the Additional Reserve was computed or estimated on the basis of a recognized mortality table and assumed rates of interest in conformity with Section 801(b).

3. "Deficiency reserves" as defined in Section 801(b)(4) are excluded from life insurance reserves and total re-

serves (App. D at 37A, 38A). Legislative history indicates that Congress was concerned with the treatment under the new tax law of then existing "deficiency reserves" as required by state law. *See* H.R. Rep. No. 34, *supra,* at 751; S. Rep. No. 291, *supra,* at 800.

The meaning and function of "deficiency reserves" in the state laws are well established. As described in S. Huebner and K. Black, LIFE INSURANCE at 376 (7th Ed. 1969) (App. E. at 50A), deficiency reserves are required by the state to offset an overestimate of future annual premiums. Thus, deficiency reserves are computed on the basis of the premium-paying period for such policy. Releases from deficiency reserves occur gradually over the premium-paying period of the policy to provide for the basic policy reserve by supplementing the premiums being charged. Therefore, the deficiency reserve disappears at the end of the premium-paying period. See also D. McGill, *supra,* at 243-245; D. Gregg, *supra,* and J. Magee, LIFE INSURANCE (5th Ed. 1958). The Additional Reserve has none of the foregoing attributes. It was established to provide for the payment of insurance benefits upon maturity of the P-Policies. It was computed with reference to the expected maturity date and maturity value of the P-Policies without regard to the premium-paying period of such policies and was set aside for paid up as well as premium-paying P-Policies. Releases from the Additional Reserve occur upon maturity of the P-Policies, not periodically as premiums are paid, without reference to any premium-paying period and are for the purpose of providing for benefits payable, not to supplement a premium payment. The Additional Reserve was not designated as a deficiency reserve by the New Jersey State Department and is not a deficiency reserve within the meaning of Section 801(b)(4). To characterize the Additional Reserve as a "deficiency reserve" would mean that the Additional Reserve would be a deficiency reserve for tax purposes but not for state regulatory purposes. Such was not the intent of Congress.

CONCLUSION

This petition for a writ of certiorari should be denied.

June 12, 1974

Respectfully submitted,

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APPENDIX A

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 3671-70. Filed July 27, 1972

A reserve to fund the additional cost of providing annuities to the beneficiaries under its life insurance policies, expressly authorized by State statute, which became subject to the regulatory authority of the State commission, qualified as a life insurance reserve within the meaning of sec. 801(b).

Henry W. Connelly, Charles W. Kappes, Michael J. Walsh, and *James A. Guadiana,* for the petitioner.

Gerald Backer, for the respondent.

QUEALY, *Judge:* The respondent determined deficiencies in petitioner's income taxes as follows:

Year:	*Deficiency*
1958	$295,077.97
1959	296,495.14
1960	296,297.16

The sole question involved is whether an additional reserve established by the petitioner to supplement the basic policy reserve in meeting its obligations under the optional mode of settlement contract embodied in certain of its policies qualified during the years 1958, 1959, and 1960 as a life insurance reserve as defined in section 801(b).[1]

[1] All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

The Mutual Benefit Life Insurance Co. (hereinafter referred to as the petitioner) is, and was at all times material herein, a mutual life insurance company incorporated by act of the New Jersey Legislature on January 31, 1845.

The petitioner's principal place of business is now, and was at the time of filing its petition, located in Newark, N.J. The petitioner timely filed its Federal income tax returns for the taxable years ended December 31, 1958, December 31, 1959, and December 31, 1960, with the district director of internal revenue, Newark, N. J. Said tax returns were prepared on the basis of an accrual method of accounting.

The petitioner is subject to the provisions of the New Jersey State laws applicable to the operation of mutual life insurance companies and to the regulations promulgated pursuant to such laws by the State of New Jersey Department of Banking and Insurance.

Life insurance policies issued by the petitioner from 1908 through September 16, 1945 (hereinafter referred to collectively as the P-Policies) provided that the policyholder, prior to maturity of the policy, or the beneficiary, upon the maturity of the policy, might elect either (1) to leave the policy proceeds with the petitioner at interest; (2) payment of the proceeds in installments for a period certain (i.e., a guaranteed income for a minimum period regardless of the life of the beneficiary or beneficiaries); or (3) the payment of a specified amount for a period certain continuing for the life of the beneficiary or beneficiaries. The option with a life contingency, the third category

described, is hereinafter referred to as the settlement option.

The payments to be made in the settlement options under the P-Policies were embodied in a schedule setting forth the dollar amount of each installment payment for each $1,000 of insurance, in accordance with (a) a period certain; (b) the frequency of payment; (c) the age or ages of the beneficiary or beneficiaries; and (d) in certain policies, the sex of the beneficiary or beneficiaries. Under the terms of the P-Policies, the installments payable under the settlement options were guaranteed, and the petitioner was bound to pay such amounts. From time to time, the petitioner changed both the policy forms used in issuing the P-Policies and the actuarial assumptions used in constructing the schedule for this settlement option, as follows:

(1) The payments under the settlement option contained in the policy forms adopted in 1908 were computed by the petitioner on the basis of interest at the rate of 3 percent per annum for the period certain and on the basis of McClintock's Mortality Table—Females and interest at the rate of 3½ percent per annum for the deferred life period following the period certain.

(2) The payments under the settlement option contained in the policy forms adopted in 1922 were computed by the petitioner on the basis of the American Experience Table of Mortality and interest at the rate of 3 percent per annum.

(3) In 1932, the petitioner adopted a retirement endowment policy form which introduced a joint and survivor settlement option. The payments under this joint and survivor settlement option were computed by the petitioner on the basis of interest at the rate of 3 percent per annum for the period certain and on the

basis of the American Annuitants' Table, adjusted by rating down 1 year in age for males and 5 years in age for females and by using only the ultimate portion thereof, and interest at the rate of 3½ percent per annum for the deferred life period.

(4) In 1936, the petitioner adopted a retirement endowment policy form which contained settlement options for use in insuring females. The payments under this settlement option were computed by the petitioner on the basis of the American Annuitants' Table for male lives, adjusted by rating down 1 year in age for males and 5 years in age for females, and interest at the rate of 3 percent per annum.

(5) In 1938, new policy forms were adopted by the petitioner for all plans of insurance. These forms contain settlement options, the payments under which were computed by the petitioner on the basis of interest at the rate of 3 percent per annum for the period certain and for the deferred life period on the basis of the American Annuitants' Table for male lives, adjusted by rating down 3 years in age for males and 7 years in age for females and by using only the ultimate portion thereof, and interest at the rate of 3½ percent per annum.

Following the issuance of the P-Policies, there was a substantial lengthening of the life expectancy at all ages and a corresponding decrease in the rate of mortality. As a result, it became apparent that the lump-sum payment otherwise due on a policy, which was reflected in the reserve, would be inadequate to fund the petitioner's liability in the event that the insured or the beneficiary elected the settlement option.

The decrease in the rate of mortality also resulted in the realization of additional income to the petitioner from these same policies by reason of the fact that petitioner was receiving premiums for a greater

number of years and in an amount in excess of the amount required to make payment of death claims under the policies. However, the excess in premiums received during the life of the policy was either distributed to the policyholder in the form of dividends or became a part of the surplus.

As a result of the foregoing, when a beneficiary elected the optional settlement under the P-Policies, the amount provided to pay death benefits was less than the amount that was required as a reserve for the annuity payments. This difference the petitioner denominated as "strain." The strain experienced by the petitioner upon an election differed depending upon the age and sex of the beneficiary.

Prior to the year ending December 31, 1946, the petitioner determined the actual strain at the time that the election of the settlement option became effective. At that time, the difference between the policy reserve and the amount required to fund the settlement option was charged against current surplus. Such a charge reduced the amount of current income available to the policyholders. As a result, the additional cost required to fund the settlement option served to increase the net premium cost of the remaining policyholders.

In the year 1946, the legislature of the State of New Jersey enacted a bill, appearing as section 17:34–22.1 of the New Jersey Statutes Annotated, as follows:

Sec. 17:34—22.1 Additional reserves

> Subject to the approval of the commissioner, any life insurance company of this State may set up, in addition to the reserve liabilities required pursuant to section 17:34–22 of the Revised Statutes, reserves to provide for any additional liability at maturity, on the basis of rates of interest and of mortality appropriate to the valuation of annuities, on policies

under which by their terms or otherwise a right has been or may be exercised to elect optional modes of settlement.

The commissioner shall, at the time of the annual valuation pursuant to section 17:34–22 of the Revised Statutes, make or cause to be made a valuation of the additional reserves so set up, and shall thereupon include the amount of such additional reserves in any certification of reserves made pursuant to section 17:34–22 of the Revised Statutes, specifying the mortality table or tables and rate or rates of interest used in the calculation of such additional reserves.

The basis of such additional reserves set aside by any company at the close of any year shall not thereafter be changed to a basis producing smaller aggregate reserves except upon approval by the commissioner of the company's application therefor. * * *

Following the enactment of section 17:34–22.1 of the New Jersey Statutes, the petitioner set about to establish, as of December 31, 1946, an additional reserve to provide for the settlement options contained in the P-Policies not yet matured (hereinafter referred to as the additional reserve). In computing the additional reserve, the petitioner adopted the 1937 Standard Annuity Mortality Table, adjusted by rating down 1 year in age, and an assumed rate of interest of 2¾ percent in the manner described below.

In the application of this table, however, it was necessary also to determine with respect to the P-Policies (a) the projected rate of election of settlement options; (b) the age and sex of beneficiaries; (c) the amount of the policy proceeds which become subject to election; and (d) the future date on which such election would become effective.

In determining the amount which would be required as an additional reserve for the P-Policies, the peti-

tioner first assumed that its additional liability, or strain, would remain at a constant percentage of policy proceeds arising from all death claims and endowment maturities under the P-Policies. This percentage was obtained by dividing the additional amounts needed in past years to provide for such additional liability on the basis of the 1937 Standard Annuity Mortality Table, adjusted, and an assumed rate of interest of 2¾ percent, by the policy proceeds arising from all death claims and endowment maturities for such past years.

The additional reserve requirements determined by the petitioner as of December 31, 1946, was thus based on the assumption that the actual strain which petitioner had experienced in the year 1945, as compared to the death proceeds paid in that year, would be in the same proportion in each succeeding year for the duration of the P-Policies. The strain thus computed was discounted at 3 percent per annum, which resulted in the estimate that approximately $37 million would be required for the additional reserve to fund the optional settlement costs as of December 31, 1946. Due to the fact that the charge of the full amount to surplus in that year would result in a corresponding reduction in the dividends payable to its policyholders, the petitioner elected not to set up the full amount of its estimate. In lieu thereof, lesser amounts were set up each year thereafter until the year ending December 31, 1953, when the additional reserve amounted to approximately $21,404,000. This amount remained fairly constant thereafter. As of December 31, 1956, the additional reserve amounted to approximately $21,200,000.

In computing the additional reserve which would be required as of January 1, 1957, the petitioner took into account its experience for the years 1952

through 1956, both inclusive. It determined the strain (additional liability) ratios for each such year by dividing the aggregate of initial reserves established on the basis of the 1937 Standard Annuity Mortality Table, adjusted, and an assumed rate of interest of 2¾ percent, less proceeds applied pursuant to settlement option elections, by the total proceeds maturing as death claims and endowments in each of these past years. The resulting strain as determined by petitioner was, as follows:

Year:	*Ratio*
1952	0.02284
1953	.02754
1954	.02647
1955	.02217
1956	.01972

The proceeds under the P-Policies amounted to approximately $200 million with an average policy size of $9,000 to $10,000, so that the number of P-Policies subject to settlement option elections was approximately 20,000 policies. The average strain ratio for this 5-year period was 0.02375.

The 1952-56 average strain of 0.02375 was then applied to the expected death claims and endowment maturities for each year beginning with 1957 and ending with 2031 (the year in which it was expected that the youngest P-Policyholder would reach age 96). Future death claims and endowment maturities were obtained by the use of the petitioner's mortality experience for 1952 through 1956 and a lapse rate of 1.75 percent which was also arrived at on the basis of the petitioner's experience.

Upon the basis of these calculations, the petitioner determined the amounts which would be required to meet the strain for the years 1957 through 2031. These amounts were then discounted to January 1, 1957, on the basis of an assumed rate of interest of 3 percent. In accordance with this procedure, the additional re-

serve required as of January 1, 1957, was determined to be $18,586,369.[2]

Using the same method of computation for the years 1957, 1958, 1959, and 1960, inclusive, the projected strain and actual strain were, as follows:

Year	Projected strain	Actual strain
1957	$1,015,729	$999,065
1958	1,055,444	907,217
1959	1,077,265	916,560
1960	1,093,449	841,529

Since the actual strain for 1957, and 1958 approximated the projected strain under the 1957 computation, the petitioner, with the consent of the New Jersey commissioner of banking and insurance, computed the additional reserve at December 31, 1957, 1958, 1959, and 1960 by increasing it by an assumed interest rate of 3 percent and reducing it by the actual strain for each year. The petitioner proposed "to continue this practice in the future until developments indicate that this course is not appropriate."

The amount of the additional reserve at January 1, 1958, 1959, and 1960, and December 31, 1958, 1959, and 1960, and the mean for the years 1958, 1959, and 1960 were as follows:

	January 1	December 31	Mean of year
1958	$18,129,909	$17,752,981	$17,941,445.00
1959	17,752,981	17,355,262	17,554,121.50
1960	17,355,262	17,021,768	17,188,515.00

[2] This sum was $2,668,160 less than would have been required on the basis of the computation of the additional reserve originally made in 1946. The original computation made in 1946 followed the same methodology as the aforesaid 1957 calculation except that the 1941 Basic C.S.O. Table was used with respect to the life expectancies of the underlying insured persons instead of the petitioner's 1952-56 mortality experience.

The 3-percent interest addition to the reserve in each of the years 1958, 1959, and 1960 was $530,289, $518,841, and $508,035, respectively.

By reason of the fact that in each of the years 1958, 1959, and 1960, the additional reserve was computed by subtracting the actual strain from the opening balances in each year (as above described) petitioner necessarily reported no underwriting income from the annual reductions to the reserve.[3]

The additional liability of the petitioner under the settlement options contained in the P-Policies could not be provided for by means of the basic policy reserve held under section 17:34–22 of the New Jersey Statutes, nor by way of a change in the mortality or interest assumptions used in the calculation thereof.

At the time the gross premiums charged for the P-Policies were computed, it was assumed that the policy proceeds alone would fully fund the settlement options contained therein. Therefore, no portion of the premium was specifically or separately charged for the inclusion of the settlement options. The petitioner paid dividends on all of the P-Policies which were participating policies in each and every year. Beginning in 1948 and continuing through 1962, these P-Policy dividends were reduced because of dividend charges made in order to restore the amounts which were previously transferred from surplus to the additional reserve. Accordingly, the establishment of the additional reserve enabled the petitioner to assess the cost of the additional liability under the settlement options against the P-Policyholders.

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[3] In adopting this method of accounting, the petitioner achieved the same result that was provided for by the exclusion in sec. 801(b)(4) of deficiency reserves. H. Rept. No. 34, 86th Cong., 1st Sess., p. 18, 1959-2 C.B. 748.

During the years in issue, the petitioner held deficiency reserves required by the laws of the State of New Jersey with respect to certain life insurance and annuity policies. None of these deficiency reserves included the additional reserve or were related to the settlement options contained in the P-Policies.

OPINION

Petitioner is a mutual life insurance company organized under the laws of the State of New Jersey. Life insurance policies written by the petitioner provided for an election to receive the proceeds in installments payable for a period certain and continuing for the life of the beneficiary. At the time the policies were written, the amounts thus payable were determined by reference to the then current mortality tables and an interest factor predicated upon the estimated rate of return which would be realized by petitioner from the investment of its reserves.

During the intervening years between the writing of such policies and the occurrence of the insurable event, that is the death of the insured, there was a substantial increase in life expectancy at all age levels. In other words, both the insured and the beneficiaries of such policies were living on the average many years longer than the anticipated life expectancy which was used as a basis for fixing the premiums in the policies and the installments payable to the beneficiaries in the event of the election of the optional settlement. The basic policy reserve, which was predicated on the payment of a sum certain upon the death of the insured, was inadequate to fund the life annuity of those beneficiaries who were entitled to receive a specified amount in installments payable for a period certain and continuing for their respective lives. This inadequacy was termed "strain" by the petitioner.

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Prior to the years ending December 31, 1946, the amount of strain which was experienced on account of the election of the optional settlement was determined as of the date of death of the insured and the resulting deficiency served to reduce surplus. In other words, the strain became a current charge to operations at the time the election took effect and an annuity reserve was set up to provide for the payments thereunder.

During the year 1946, the legislature of the State of New Jersey enacted section 17:34—22.1 of the New Jersey Statutes which permitted, *but did not require*, the maintenance of an additional reserve to provide for any additional liability at maturity on the basis of rates of interest and of mortality appropriate to the valuation of annuities on account of life insurance policies which granted the right to elect optional modes of settlement. The statute further provided that the basis of such additional reserve shall not thereafter be changed to a basis producing smaller aggregate reserves except upon approval by the New Jersey commissioner of banking and insurance.

Prior to the years involved in this case, the petitioner had duly elected to establish an additional reserve on a basis which had been approved by the New Jersey commissioner of banking and insurance. Thus, over a period of years, an appropriate reserve had been set up voluntarily by the petitioner and upon a basis largely of petitioner's own choice. Having established such a reserve, the sole question for decision is whether the reserve qualifies as a "life insurance reserve" within the meaning of section 801(b), thereby entitling the petitioner to the exclusion provided in section 804(a). Insofar as material herein, section 801(b) provides as follows:

(b) LIFE INSURANCE RESERVES DEFINED.—

IN GENERAL.—For purposes of this part the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) RESERVES MUST BE REQUIRED BY LAW.—

Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

(B) * * *

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

At the outset, respondent argues that in enacting the Life Insurance Income Tax Act of 1959 it was the intent of Congress to tax alike all life insurance companies. The respondent contends that allowing the petitioner to set up a life insurance reserve for the anticipated strain would result in a tax advantage to the

petitioner in relation to other life insurance companies not having such reserves. Since any decision with respect to the qualification of a reserve for the purpose of funding the annuity option in life insurance contracts would apply to all life insurance companies having such contracts, we regard respondent's argument wholly irrelevant to the issue in this case. The tax laws are replete with so-called tax preferences for those who qualify.

The respondent also contends that the additional reserve does not qualify as a life insurance reserve because it was not "computed or estimated on the basis of recognized mortality or morbidity tables" as required under section 801(b). Respondent argues that in the instant case there was involved the added element of uncertainty stemming from the election with respect to the settlement options and the uncertainty with respect to the age and sex of those electing in the future. Admittedly, however, it was the change in mortality rates predicated upon recognized tables that resulted in the inadequacy of the initial reserve to fund the settlement option. The determination of the amount required to fund the annuity at any specific age could be arrived at solely by reference to mortality tables and assumed rates of interest. Admittedly, it was also necessary to include in any computation of the reserve an assumed ratio of selection and the weighted average age or life expectancy of the beneficiary at the time of making the choice. Thus, while recognized mortality tables formed the basis of the petitioner's calculations of the reserve, the rate of selection and the profile of the annuitant had to be determined upon the basis of experience.

Respondent does not suggest that some other method would produce a different result. Rather, the respondent argues that the method itself goes beyond

the use of recognized mortality tables. If such judgments were not an integral part in the computation of insurance reserves, we would hardly have need for actuaries. The so-called actuary would still be known as the mathematician.[4] In our opinion, the combination of mortality tables and actual experience used by the petitioner to determine in the first instance the amount required to fund its liability for the settlement option under the P-Policies was within the scope of the statute.[5]

The respondent also points out that having determined the amount of the reserve which would be required, petitioner did not in a single year set up a reserve for the full amount that was thus determined. Charging the full amount to the reserve in one year out of its surplus would have made a corresponding reduction in dividends payable on account of its policies. Petitioner concluded that such reduction would be excessive. Assuming that a charge of the full amount to reserve in one year would have qualified as a life insurance reserve, the election by the petitioner to set up a lessor amount in each year over a period of years would not make the amount thus set aside any less qualified. *Lamana-Panno-Fallo I. Ins. Co.* v. *Commissioner,* 127 F. 2d 56 (C.A. 5, 1942).

Finally, we think it is clear that the reserve required to fund the optional settlement cannot be distinguished from the obligation of the petitioner to pay a death benefit under a life insurance contract. De-

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[4] When petitioner was incorporated in 1845, its charter provided that there be a "mathematician," and petitioner's chief actuary is still known by that title.

[5] The reference to "recognized mortality or morbidity tables" first appeared in the Revenue Act of 1942. It was intended to expand, not to restrict, the definition of life insurance reserves. S. Rept. No. 1631, 77th Cong., 2d Sess., p. 145, 1942-2 C.B. 612.

pending upon changes both with respect to mortality rates and interest yields, the basic reserve under the contract could have been either greater or lesser than the amount required to meet petitioner's obligations under the optional settlement clause. Any additional reserve designed to provide for a deficiency in the basic reserve constitutes a reserve for the purpose of meeting the anticipated future obligation to pay benefits under a life insurance contract. The fact that such benefits may be payable in the form of an annuity, rather than a lump sum, does not change the character of contract.

We thus come to the basic question in this case, namely, whether it can be said that the additional reserve was "required by law" within the meaning of section 801(b)(2). The respondent contends that, since section 17:34–22.1 of the New Jersey Statutes provided in the first instance for a reserve that was discretionary or permissive, it was not required by law. On the other hand, the petitioner contends that the additional reserve was required by law since, once established, such reserve could not be diminished without the approval of the commissioner of insurance for the State of New Jersey.

On its face, the phrase "required by law" would appear to exclude a reserve which in the first instance was permissive rather than mandatory. In the taxation of the life insurance industry, however, we must look beyond the ordinary meaning of the words in the statute. *Alinco Life Insurance Co.* v. *United States*, 373 F. 2d 336, 352-353 (Ct. Cl. 1967).

Except for the reference to "recognized mortality or morbidity tables" the definition of life insurance reserves in section 801(b) was a codification of the respondent's regulations antedating the Revenue Act of 1942. S. Rept. No. 1631, *supra*. As used in those regu-

lations, the phase "required by law" referred not only to duly enacted State laws but to rules and regulations promulgated by duly authorized State regulatory agencies.[6] Section 1.801-5(b), Income Tax Regs., defines "required by law" as follows:

> (b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

Section 17:34-22.1 of the New Jersey Statutes not only permitted the setting up of a reserve for a recognized risk, but further provided that:

The basis of such additional reserves set aside by any company at the close of any year shall not thereafter be changed to a basis producing smaller aggregate reserves except upon approval by the commissioner of the company's application therefor. * * *

It cannot seriously be argued that the additional reserve voluntarily set up by the petitioner prior to the years before the Court was not required to be maintained by virtue of the regulatory power specifically granted to the State commissioner of banking and insurance. In the taxable years under consideration, therefore, there was on the books of the petitioner a reserve established in prior years pursuant to State law which had achieved the status of a reserve required to be maintained under the regulatory authority of the State agency. If we look to the re-

[6] Regs. 103, sec. 19.203(a)(2)-1.

spondent's regulations, this is tantamount to being "required by law" within the meaning of section 801(b).

As of January 1, 1958, the petitioner's additional reserve was "required" to be maintained by the commissioner of banking and insurance and was reported in the annual statements of the petitioner and accepted by the commissioner as held for the fulfillment of claims. It is our conclusion, therefore, that the additional reserve qualified as a life insurance reserve within the meaning of section 801(b).

In reaching this conclusion, it is not our intention to approve the manner in which the petitioner accounted for this reserve during the years in question. It would appear that the petitioner sought thereby to achieve the same result that was provided for by the Congress in excluding deficiency reserves from the overall computation of life insurance reserves.) If it was necessary specifically so to exclude deficiency reserves under section 801(b)(4), it would seem to follow that proper credits and debits to other life insurance reserves not specifically so excluded should be taken into account in determining the tax base. However, the election of the petitioner to adjust the reserve on account of an assumed interest rate of 3 percent and reduce it by the actual strain for each year does not disqualify the reserve under section 801(b).

Reviewed by the Court.

Decision will be entered under Rule 50.

APPENDIX B

United States Court of Appeals for the Third Circuit

No. 73-1169

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY,
APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

Appeal From the United States Tax Court

Argued September 25, 1973

Before: Seitz, Chief Judge and Hunter and Weis, Circuit Judges

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Opinion of the Court

(Filed December 12, 1973)

WEIS, *Circuit Judge:* While there are many who complain that the Internal Revenue Code is incomprehensible, there are some few who revel in the intricacies of its labyrinthine composition. But those who take delight in such pursuits and who also understand the mystic processes of establishing reserves in the life insurance industry are an even rarer specie of the ornithological world. Such are the vagaries of assignments, however, that it has fallen to the lot of this panel to decide a case where the two sciences conjoin. We therefore tread into the thicket with some trepidation.[1]

[1] No less an authority than Learned Hand once said, "In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave my mind only a confused sense of something vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time." Hand, *Eulogy of Thomas Walter Swan*, 57 Yale L.J. 167, 169 (1947).

The immediate question before us is whether the Tax Court properly decided that amounts allocated by the petitioner Insurance Company to an "additional reserve" qualify as "life insurance reserves" under Section 801 of the Internal Revenue Code of 1954 and the Life Insurance Company Tax Act of 1959, 26 U.S.C. § 801.

The problem is complicated by the fact that in the life insurance industry, as in many others, words acquire a technical significance, and the first step to confusion is to read these special terms as if they mean what they seem to mean. Thus, at the very outset, it is appropriate to note that contrary to generally held belief, "reserves" are not trust funds or assets in escrow but factually are merely statements of liability, involving no representation that specific assets are held to meet any particular claim or class of claims.[2] We are concerned here, therefore, with the computations of an amount which is to be entered on the balance sheet of an insurance company as a debit and, thus, has significant tax consequences.

The dispute here has its origin in a real life situation, to be exact, the substantial lengthening of life which occurred during the first half of the twentieth century.

Beginning in 1908 and continuing through 1945, the Insurance Company sold a series of life policies (called P-Policies) which gave the beneficiary the privilege of electing one of several methods of settlement in lieu of the customary face value lump sum payment. The option of concern here gives the beneficiary the right to receive payments for the rest of his life, but in no event for less than a stated number

[2] Knickerbocker, *The Present Status of Life Insurance Reserves*, 23 Tax Lawyer, Winter 1970, 367, 374 n. 22. 8 Mertens, *Law of Federal Taxation*, § 44.26 n. 1.

of these installments. The amount of each payment (which varies with the age of the beneficiary) is fixed and set forth in tables printed in the policy.

The tables were prepared on the assumption that the lump sum payment and the installment option would be roughly equivalent in value so that the liability of the Company in either event would be the same. However, as time went on and the lives of beneficiaries lengthened, it became obvious that the liability of the Company to meet the annuity-type option was becoming substantially greater than the lump sum payment. This situation developed because the amount of each monthly payment was fixed by the tables in the original policies based on life expectancies which were prevalent at that time. Since the beneficiaries began to live longer than the Company had anticipated at the time it wrote the contract, more payments were required and, hence, a greater total expenditure became necessary.

The petitioner had its headquarters in New Jersey, and that state's insurance laws required the Company to enter on its books annually a "basic reserve" which represented the amount that would be needed to meet the obligation to pay the face amounts of policies which became collectible that year. So long as the costs of lump sum payments and the time payment option were about the same, the accounting procedure was satisfactory and accurately reflected the Company's liabilities. When, however, the increasing longevity of beneficiaries required payment of sums beyond the amount of the basic reserves, an accounting problem was created.

The difference in amounts between the "basic reserve" and that required to settle under the settlement option was called "strain." Before 1946, the Company took the amount of "strain" from current surplus at

the time that a beneficiary elected to receive the payment option. The problem became increasingly acute, and in 1946 the Legislature of New Jersey enacted a statute (N.J. Stat. Ann. § 17:34–22.1) permitting an insurance company to set up "additional reserves" to meet the anticipated "strain" situation in future years.[3]

The statute provided that the establishment of such reserves initially would be voluntary but that once a company had availed itself of the privilege, reserves could not be changed to a basis producing smaller amounts thereafter except with approval of the insurance commissioner.

The Company decided to avail itself of the statutory provision and computed an "additional reserve" by using:

(1) The 1941 C.S.O. Mortality Tables,[4]

(2) The 1937 Standard Annuity Mortality Table, adjusted by rating down 1 year in age,

(3) An assumed rate of interest of 2¾% and additionally: (a) Projected rate of election of the settlement option, (b) Age and sex of beneficiaries, (c) Amount of policy proceeds which

[3] Because of the requirements of state law that reserves for the lump sum payment, the "basic reserve", be calculated on a rigid formula which made no provision for meeting the annuity-type option, it was not possible to increase that reserve to meet the "strain." Thus, although the Company took in more than enough in premiums to meet the "strain" obligation, the structure of state regulation required that the amount of premiums in excess of that required to maintain the "basic reserve" be transferred to surplus or returned to the policyholder in the form of dividends. Generally the Company returned the excess amounts to the policyholder as dividends.

[4] C.S.O. is the abbreviation for Commissioner's Standard Ordinary Table. It was based on the experience of a group of the principal insurance companies from 1930 to 1940. *See*, MacLean, *Life Insurance*, 9th ed. 1962 at 72.

would become subject to election, and (d) The future date on which the election would become effective.

In computing the additional reserve requirements which would be required as of December 31, 1946, the Company assumed that the "strain" experienced in previous years, as compared to the lump sum death claims and endowment benefits paid, would remain at a constant ratio during the remaining years in which the P-Policies would be in effect, that is, to the year 2031. Rather than debit this amount in one year—which would have had a strong adverse effect on the Company surplus and reduce the dividends to policyholders—it was decided to strengthen the reserves over a period of years until the desired level was achieved. The computations and procedures followed by the Company were approved by the Insurance Commissioner of New Jersey.

As of December 31, 1956, the "additional reserve" amounted to $21,254,529.00. It was then decided to recalculate this reserve by utilizing the Company's experience during the preceding five years, that is, 1952 to 1956 inclusive. This resulted in a reduction for 1957 to $18,586,369.00.

In computing the "additional reserve" in 1956, the Company followed basically the same formula except that in this later calculation the mortality experience of the Company during the years 1952–1956 was used to determine the life expectancy of the *insured person* instead of the 1941 mortality table which was used in the 1946 calculation.[5] Both calculations, however, relied upon the use of the 1937 Standard Annuity Mortality Table in estimating the life of the *beneficiary* under the settlement option.

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[5] Findings of Fact of the Tax Court, n. 2.

The 1957 calculations were approved by the New Jersey Insurance Commissioner and resulted, as has been seen, in a reduction in the amount of the "additional reserve" from that which would have been applicable under the original calculation.[6] Similar mechanics were followed in determining the "additional reserve" for 1958, 1959 and 1960. The "additional reserves" as of December 31 for those respective years were $17,752,981.00; $17,355,262.00; and $17,021,768.00, respectively.[7]

The Commissioner assessed a deficiency for each of those years. After a trial, the Tax Court found against the Commissioner and determined that no deficiencies existed.[8]

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[6] This circumstance would result in a lesser exclusion, and hence the change in the Insurance Company's reserves would not adversely affect the government. Ordinarily one would not expect the Commissioner to object to such action. However, his attack here is to refuse recognition to the reserve in its entirety, claiming that the additional factors which were used to reduce the reserve destroyed its eligibility for inclusion altogether.

[7] The basic 1956 calculation was utilized in determining the 1958, 1959 and 1960 reserves. This was done by a method of increasing the reserve by 3% per year (the same yearly percentage which had been used in discounting the amount originally projected for the whole period of the P-Policy) and then deducting the actual "strain" incurred during each year. We are not called upon to pass on this particular accounting procedure since we are concerned in this appeal only with the determination of whether the reserves are properly denominated as insurance reserves.

[8] A more detailed statement of the facts and the mathematical computations involved may be found in the opinion of the Tax Court, 58 T.C. No. 69, Docket No. 3671-70, Filed July 27, 1972. We have limited our recitation of the factual background to that necessary for an understanding of the legal issues.

The Commissioner contends that the "additional reserves" do not qualify as life insurance reserves under the Act because:

> (1) Section 801(b)(2) requires that the establishment of the reserves be "required by law" and since the Insurance Company voluntarily established the reserve initially, that qualification was not met.
>
> (2) The Act, Section 801(b)(1)(a) defines a reserve as one computed on the basis of mortality tables and an assumed rate of interest. Therefore, since the calculations here used additional factors, such as lapse rate, rate of election, and company experience, the Commissioner contends that the reserve lost its eligibility to be considered as a life insurance reserve.
>
> (3) The Code excludes "deficiency reserves," and its definition would include the "additional reserve" here.

We first consider the qualification that the reserve be required by law. The income tax regulations, Section 1.801–5(b), defines "required by law" as follows:

> For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

The New Jersey statute applicable, that is, Section 17:34–22.1, permitted the setting up of an additional reserve but imposed the restriction that "The basis of such additional reserves set aside by any company at the close of any year shall not thereafter be changed

to a basis producing smaller aggregate reserves except upon approval by the commissioner of the company's application therefor* * *."

Thus, while the initial decision to set up a reserve was entirely voluntary, its continuance was not. What the Company did in 1946 was of its own choosing, but in 1958 to 1960 it was not free to drop the reserve or to alter its formulation without having specific permission from the Insurance Commissioner.[9] To argue that the Company was not required to carry the reserve in the years in question is to ignore reality. A man who volunteers for the Armed Forces is as subject to its discipline and regulations thereafter as any other person in service. His voluntary act in enlisting does not give him the right thereafter to question the lawful exercise of authority by his superiors. A man may enter into a marriage voluntarily, but that is not a reason to limit his obligation imposed by law to support his family. Similarly here, the Company could elect to take action permitted by the New Jersey statute, but when it did take that step, it did submit itself to the requirement that the reserve be continued thereafter. A fair reading of the income tax regulation requires us to conclude that in 1958-1960, the reserve was "required by law."

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[9] While not binding on this Court or the Tax Court, the opinion of the Insurance Commissioner of New Jersey who was charged with administration of the state law is entitled to some weight. He testified that "To the extent that the reserve was established, at that point it was required by law because it required the approval of the Commissioner for it to be reduced or eliminated." (Transcript of Testimony, p. 51). *See also* Knickerbocker, *supra*, n. 2 at 375:

"However, once the company has established such a reserve, the company is no longer free to reduce or eliminate the reserve as long as it remains subject to the risk so represented, unless permission to adjust the reserve is granted by the state insurance department."

Next we consider whether the "additional reserve" was a "life insurance reserve" within the meaning of the Code. It seems clear that the establishment of the "additional reserve" was the exercise of good business judgment, was in the best interest of policyholders and beneficiaries, and had the approval of the State of New Jersey. Admittedly, however, these factors are not determinative when definitions under the tax laws of the United States are involved.

Taxation of insurance companies has always involved some specific treatment by Congress in recognition of the peculiar nature of the industry. Thus, it has been acknowledged that part of the money taken in by the Company as premiums and part of the money earned on investments really belong to the policyholders. *United States* v. *Atlas Life Insurance Co.*, 381 U.S. 233, 247, 85 S. Ct. 1379, 14 L. ed. 2d 358 (1965). Accordingly, it became necessary to make provision for accounting procedures to be consistent with this approach by incorporating the use of "reserves."[10]

In 1942 Congress defined reserves as being based on recognized mortality tables and an assumed rate of interest. The definition was intended to broaden the concept of reserves rather than to restrict it.[11] There is no indication since that time that Congress intended to exclude other factors which would make the calculations of the reserve more precise or accurate. Indeed, in the 1959 Life Insurance Company Tax Act Congress

[10] 8 Mertens, supra, n. 2, §§ 44.16, 44.17.

[11] S. Rep. No. 1631, 77th Cong., 2d Sess. (1942), reprinted in 1942-2 C.B. 504.

recognized that a company might determine that it was necessary to weaken or strengthen its reserves.[12]

The pertinent portion of the statutory definition, 26 U.S.C. § 801(b)(1), reads:

> * * * 'life insurance reserves' means amounts
> (A) which are computed or estimated on the basis of recognized mortality * * * tables and assumed rates of interest, and
> (B) which are set aside to * * * liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance * * * contracts * * * involving, at the time with respect to which the reserve is computed, life * * * contingencies.

It may be seen that the "basic reserve" applicable to a lump sum payment is fully covered by this definition.

The Commissioner appears to argue that the "additional reserve" does not qualify because the optional mode of settlement involved in this case does not create any liability on the insurance company until such time as elected by the beneficiary. The Commissioner characterizes the transaction as the purchase of an annuity by a beneficiary with the lump sum proceeds of the policy.

We disagree and find that the insurer, in making payment under the specific settlement option involved in this controversy, does not enter into a new contract with the beneficiary but merely carries out the contractual obligation which arose with the initial issu-

[12] Sections 806(b) and 810(d); *See also*, H.R. Rep. No. 34, 86th Cong., 1st Sess. (1959), reprinted in 1959-2 C.B. 736, 794.

ance of the life insurance contract. *See* 19 *Couch on Insurance 2d* § 81:4. We see nothing in the statute which requires the construction which the Commissioner advocates and believe it contrary to generally accepted insurance law. Indeed, the government's position would come as somewhat of a surprise to the policyholder who pays the premium with the understanding that his beneficiary has the choice to take the optional settlement—at the values set out in the policy and regardless of any inclination of the insurance company to the contrary.[13]

While it may be said that as to any one individual policy it could not be determined at issuance that the settlement option would be exercised, there is no doubt that as to the entire class of policies, utilization of the option was not speculative but a fact thoroughly established by experience in a large number of claims throughout the industry. For all practical purposes, then, the obligation of the Company to meet the "strain" was just as certain and definite as it was to meet the lump sum payment requirements for which the "basic reserve" was established.

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[13] The Senate Committee report, in discussing the definition of life insurance reserves under § 201(C)(2) of the predecessor Act, said in part, "The elimination of contingent claims from the House bill is to permit the liability arising from insurance contracts providing for the payment of the proceeds in installments certain for a specified period and a continuation of their installment payments to a beneficiary so long as he might live, to be classified as a reserve if the contract involved a life contingency even if some part of the liability was held to meet noncontingent claims." S. Rep. No. 1631, 77th Cong., 2d Sess. (1942), Reprinted 1942-2 C.B. 504, 612. We interpret this to mean that the Senate Committee could recognize a reserve to meet the settlement option contingency if it were formulated at the time the policy is issued.

The fact that the computation for the reserve included elements other than mortality tables as assumed rates of interest, is not sufficient to disqualify the "additional reserve." There is nothing in the statute which states that these two elements are the only factors which are permissible and that all others must be excluded. In the factual context present here, we can perceive no considerations which would require us to adopt a construction of the Act so narrow as to mandate the exclusion of circumstances which would tend to make the calculation of the reserve more exact.

Congress obviously sought to prevent abuse, and with this, of course, we thoroughly agree. The additional elements used here accomplished exactly what Congress did intend. We cannot ignore the fact that the additional elements of lapse rate, rate of election, and lowered mortality rates of the insured resulted in substantial reductions of the reserve. The recalculation to the lower levels in 1956 was at the request or insistence of the New Jersey Insurance Commission which felt that the reserves were higher than need be. In a real sense then the adjustment of the reserves and inclusion of additional elements was necessary to establish compliance with New Jersey law. We need not hold that this action was necessary to meet the "required by law" test but we do note that Congress was aware of the extensive, continuing supervision of the insurance industry by the states. It is obvious that subjecting the reserves to the scrutiny of the state regulatory agencies is an additional safeguard against overreaching by the companies.

There was testimony in this case to establish that if the challenged elements had not been used in the

computations, the reserves would have been four or five times as high and would have been considered excessive by New Jersey. The substantial actuarial data used in this case and the approval by the State Commission which resulted in a realistic rather than an inflated reserve lead us to conclude that a tunnel vision approach to the Act here would result in distortion rather than a proper construction. The "additional reserve" represented money due the policyholders just as truly as did the "basic reserve."

The final shot fired by the Commissioner is that the "additional reserve" is a "deficiency reserve" and, thus, specifically excluded by the Code. The first and obvious question is, what is a "deficiency reserve." It is a technical term having a specific meaning in the industry which must be used in interpreting the definition of the Act. *Alinco Life Insurance Company* v. *United States,* 373 F. 2d 336 (Ct. Cl. 1967).

The statutory definition, 26 U.S.C. § 801(b)(4), reads:

> * * * that portion of the reserve * * * equal to the amount * * * by which—(A) the present value of the future net premium required for such contract, exceeds (B) the present value of the future actual premiums and consideration charged for such contract.

The "deficiency reserve" is a concept in the industry which resulted from the rigid formulas imposed by state regulatory agencies in calculating "basic reserves." Many states required that the "basic reserve" for a policy was to be computed on the basis of the experience or mortality table in use at the time the policy was sold even though it was known at that time that life expectancy was increasing. This meant that in many instances the reserve was computed on the basis of a life expectancy lower than reality and

therefore the premiums charged would be larger than necessary. Some companies set premium levels which they felt were adequate in view of the lengthening of life expectancy but which were less than that which strict adherence to the tables would require. The state required that in such a situation a "deficiency reserve" be set up to account for the difference between the premiums which should have been charged according to the mortality tables and those which were actually paid by the policyholder.[14]

It may be seen that one of the distinguishing characteristics of a "deficiency reserve" is that it is calculable at the moment of issue of a policy. At that time, the premium actually charged and that required by the standard mortality table are known and the "deficiency" in premium may easily be established. The adoption of updated and more accurate mortality tables resulted in the elimination or decrease of many "deficiency reserve" requirements for policies sold thereafter.

A "deficiency reserve" is not used to increase a policy "basic reserve" which was adequate when issued.[15] With this explanation as a background, it is clear that a "deficiency reserve" as that term is used in the industry is not applicable to an "additional reserve" which is set up after the policy is issued and to deal with problems that arose *after* issue.

When the definition in the Act is read in conjunction with the industry meaning[16] of the term, it is

[14] See MacLean, Life Insurance, (9th ed. 1962), at page 73.

[15] As one of the witnesses explained at the trial of this case, "deficiency reserves" relate only to the situation at the time a policy is issued, and there is no situation after a policy is issued which would require a "deficiency reserve".

[16] Mertens, *supra*, § 44.15 at pp. 36, 37. *See also* General Life Insurance Co. v. Commissioner of Internal Revenue, 137 F. 2d 185, 190, n. 1 (5th Cir. 1943).

clear that the Commissioner was in error in considering the "additional reserve" as a "deficiency reserve." Here the "additional reserve" could not be ascertained at the time the policy was issued, and it was established to meet events which occurred many years after issuance of the policies.

Recognizing that the unresolved problems of the tax accountability of insurance reserves are many and complex, we have trod a narrow path charted by the specific factual situations present here and our opinion should be so understood. We emerge, concluding that the decision of the Tax Court was correct, and therefore its judgment will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

United States Court of Appeals for the Third Circuit

No. 73-1169

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

Present: SEITZ, Chief Judge and HUNTER and WEIS, Circuit Judges

Order

It is Ordered that the opinion heretofore filed be corrected as follows: The last sentence of the first full paragraph on page 3 of the slip opinion shall read:

> We are concerned here, therefore, with the computations of an amount which is to be entered on the balance sheet of an insurance company as a liability and, thus, has significant tax consequences.

By the Court,

JOSEPH F. WEIS, JR.
Circuit Judge.

Dated: JANUARY 8, 1974.

APPENDIX C

United States Court of Appeals for the Third Circuit

No. 73-1169

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY

vs.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT
(T.C. Docket No. 3671-70)

On Appeal From a Decision of the Tax Court of the United States

Present: SEITZ, Chief Judge and HUNTER and WEIS, Circuit Judges

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed. Costs taxed against appellant.

Attest:

THOMAS F. QUINN,
Clerk.

DECEMBER 12, 1973.

A true copy:
THOMAS F. QUINN,
Clerk.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SECTION 801. *Definition of Life Insurance Company.*

* * *

(b) LIFE INSURANCE RESERVES DEFINED.—

(1) IN GENERAL.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) RESERVES MUST BE REQUIRED BY LAW.—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

(B) as provided in paragraph (3).

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

* * *

(4) DEFICIENCY RESERVES EXCLUDED.—The term "life insurance reserves" does not include deficiency reserves. For purposes of this subsection and subsection (c), the de-

ficiency reserve for any contract is that portion of the reserve for such contract equal to the amount (if any) by which—

(A) the present value of the future net premiums required for such contract, exceeds

(B) the present value of the future actual premiums and consideration charged for such contract.

• • •

SECTION 806. *Certain Changes in Reserves and Assets.* (a) ADJUSTMENTS TO MEANS FOR CERTAIN TRANSFERS OF LIABILITIES.—For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the mean of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

(b) CHANGE OF BASIS IN COMPUTING RESERVES.—If the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of this subpart the amount of such item—

(1) as of the close of the taxable year shall be computed on the old basis, and

(2) as of the beginning of the next taxable year shall be computed on the new basis.

SECTION 810. *Rules for Certain Reserves.* (a) ADJUSTMENT FOR DECREASE.—If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable

year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the excess shall be taken into account as a net decrease referred to in section 809(c)(2).

(b) ADJUSTMENT FOR INCREASE.—If the sum of the items described in subsection (c) as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2).

(c) ITEMS TAKEN INTO ACCOUNT.—The items referred to in subsections (a) and (b) are as follows:

(1) The life insurance reserves (as defined in section 801(b).

* * *

In applying this subsection, the same item shall be counted only once.

(d) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES.—

(1) IN GENERAL.—If the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

(A) the amount of the item at the close of the taxable year, computed on the new basis, and

(B) the amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account for purposes of this subpart as follows:

(i) if the amount determined under subparagraph (A) exceeds the amount determined under

subparagraph (B), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a net increase to which section 809(d)(2) applies; or

(ii) if the amount determined under subparagraph (B) exceeds the amount determined under subparagraph (A), 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) applies.

SECTION 818. *Accounting Provisions.* (a) METHOD OF ACCOUNTING.—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.801-4. LIFE INSURANCE RESERVES.—(a) *Life insurance reserves defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "life insurance reserves" (as defined in section 801(b)) means those amounts—

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term "reserves required by law", see paragraph (b) of § 1.801-5.

For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10, the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves. *Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years.* For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life in-

surance reserves, see paragraph (e) of this section (Emphasis added).

* * *

(d) *Reserves which qualify as life insurance reserves.* The following reserves, provided they meet the requirements of section 801(b) and paragraph (a) of this section, are illustrative of reserves which shall be included as life insurance reserves:

(1) Reserves held under life insurance contracts.

(2) Reserves held under annuity contracts (including reserves held under variable annuity contracts as described in section 801(g)(1)).

(3) Reserves held under noncancellable health and accident insurance contracts (as defined in paragraph (c) of § 1.801-3) and reserves held under guaranteed renewable health and accident insurance contracts (as defined in paragraph (d) of § 1.801-3).

(4) Reserves held either separately or combined under contracts described in subparagraphs (1), (2), or (3) of this paragraph.

(5) Reserves held under deposit administration contracts. Generally, the reserves held by a life insurance company on both the active and retired lives under deposit administration contracts will meet the requirements of section 801(b) and paragraph (a) of this section. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. See paragraph (a) of this section.

(e) *Reserves and liabilities which do not qualify as life insurance reserves.* The following are illustrative of reserves and liabilities which do not meet the requirements

of section 801(b) and paragraph (a) of this section and, accordingly, shall not be included as life insurance reserves:

(1) Liability for supplementary contracts not involving at the time with respect to which the liability is computed, life, health, or accident contingencies.

(2) In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums and unpaid losses (whether or not ascertained).

(3) The unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies (and guaranteed renewable life, or accident policies) not included in life insurance reserves. (However, such amounts shall be taken into account under section 801(a)(2) for purposes of determining whether an insurance company is a life insurance company.)

(4) The deficiency reserve (as defined in section 801(b)(4)) for each individual contract, that is, that portion of the reserve for such contract equal to the amount (if any) by which—

(i) The present value of the future net premiums required for such contract, exceeds

(ii) The present value of the future actual premiums and consideration charged for such contract.

(5) Reserves required to be maintained to provide for the ordinary operating expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage.

(6) Liability for premiums received in advance.

(7) Liability for premium deposit funds.

(8) Liability for annual and deferred dividends declared or apportioned.

(9) Liability for dividends left on deposit at interest.

(10) Liability for accrued but unsettled policy claims whether known or unreported.

(11) A mandatory securities valuation reserve.

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§ 1.801-5. TOTAL RESERVES.—

* * *

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * *

§ 1.806-4. CHANGE OF BASIS IN COMPUTING RESERVES.—(a) *In general.* For purposes of subpart B, part I, subchapter L, chapter 1 of the Code, section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) (relating to items taken into account) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then in determining taxable investment income the amount of the item as of the close of the taxable year shall be the amount computed on the old basis, and the amount of the item as of the beginning of the next taxable year shall be the amount computed on the new basis. For purposes of the preceding sentence, an election under section 818(c) shall not be treated as a change in basis for determining the amount of an item referred to in section 810(c). A change of basis in computing any of the items re-

ferred to in section 810(c) is not a change of accounting method requiring the consent of the Secretary or his delegate under section 446(e).

(b) *Illustration of change of basis in computing reserves.* The application of section 806(b) and paragraph (a) of this section may be illustrated by the following examples:

Example (1). Assume that the life insurance reserves of Y, a life insurance company, at the beginning of the taxable year 1959 are $100 and that during such taxable year a portion of the reserves is strengthened (by reason of a change in mortality or interest assumptions, *or otherwise*), so that at the end of the taxable year 1959 the reserves (computed on the new basis) are $130 but computed on the old basis would be $120. Assume further that at the close of the next taxable year, 1960, the reserves (computed on the new basis) are $142. Under the provisions of section 806(b) and paragraph (a) of this section, the mean of such reserves for the taxable year of the reserve strengthening, namely 1959, is $110 (the mean of $100, the balance at the beginning of the taxable year 1959, and $120, the balance at the end of the taxable year 1959 computed on the old basis). The mean of such reserves for the next taxable year, 1960, is $136 (the mean of $130, the balance at the beginning of the taxable year 1960 computed on the new basis, and $142, the balance at the end of the taxable year 1960 computed on the new basis) (*Emphasis added*).

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§ 1.810—2. RULES FOR CERTAIN RESERVES.—(a) *Adjustment for decrease or increase in certain reserve items*—(1) *Adjustment for decrease.* Section 810(a) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year exceeds the sum of such items at the end of the taxable year

(reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the amount of such excess shall be taken into account as a net decrease referred to in section 809(c)(2) and paragraph (a)(2) of § 1.809-4 in determining gain or loss from operations.

(2) *Adjustment for increase.* Section 810(b) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items at the beginning of the taxable year, the amount of such excess shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809-5 in determining gain or loss from operations.

(b) *Items taken into account.* The items described in section 810(c) and referred to in section 810(a) and (b) and paragraph (a) of this section are:

(1) The life insurance reserves (as defined in section 801(b) and § 1.801-4;

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§ 1.810-3. ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES.—(a) *Reserve strengthening or weakening.* Section 810(d)(1) provides that if the basis for determining any item referred to in section 810(c) and paragraph (b) of § 1.810-2 at the end of any taxable year differs from the basis for such determination at the end of the preceding taxable year, then so much of the difference between—

(1) The amount of the item at the end of the taxable year, computed on the new basis, and

(2) The amount of the item at the end of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account as follows:

(i) If the amount of the item at the end of the taxable year computed on the new basis exceeds the amount of the item at the end of the taxable year computed on the old basis, 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a net increase to which section 809(d)(2) and paragraph (a)(2) of § 1.809-5 applies; or

(ii) If the amount of the item at the end of the taxable year computed on the old basis exceeds the amount of the item at the end of the taxable year computed on the new basis, 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) and paragraph (a)(2) of § 1.809-4 applies.

* * *

§ 1.818-2. ACCOUNTING PROVISIONS.—(a) *Method of accounting.* (1) Section 818(a)(1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term "accrual method" shall have the same meaning and application in section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of expenses under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a)(2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by

chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a)(2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a)(2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales or realty and casual sales of personalty (as provided in section 453(b)). *To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.* (*Emphasis added.*)

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Proposed Treas. Reg. § 1.801-5(b), 25 Fed. Reg. 7986

(b) RESERVES REQUIRED BY LAW DEFINED.—For purposes of part I, subchapter L, chapter 1 of the Code, the term

"reserves required by law" means the amount of reserves as calculated according to the legal minimum standards of valuation prescribed either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. However, if a company holds reserves in excess of the amount calculated according to the legal minimum standards of valuation prescribed, and such additional amounts are needed to meet the nonforfeiture benefits guaranteed in contracts issued by the company, the term "reserves required by law" shall mean the amount of reserves as calculated by use of the same assumptions employed by the company in determining the nonforfeiture benefits guaranteed in such contracts, less any surrender charge made by the company.

APPENDIX E

S. Huebner and K. Black, LIFE INSURANCE at 376 (7th Ed. 1969)

The requirement of so-called deficiency reserves has long been a feature of state insurance laws; but has become much more significant in recent years. It was a prime cause in the move to develop the 1958 CSO Table and the new valuation legislation.

If the *gross premium* charged by a life insurance company for a particular class of policies should be *less* than the *valuation net premium,* the company is required to maintain for such policies a supplemental reserve, a so called *deficiency reserve.* The valuation net premium is the net premium used in the calculation of the company's policy reserves, and historically this has been considerably less than the gross premium for the various classes of policies issued. In recent years, however, continued improvement in mortality and increasing price competition brought gross premium levels down to levels approaching or even below valuation net premiums. This was particularly a problem for those smaller companies issuing nonparticipating business, with limited surplus available to establish such supplemental reserves.

Deficiency reserve laws are founded on the fact that the use, in the prospective reserve formula, of a valuation net level premium larger than the gross premium which will actually be received overstates the present value of future premiums and, consequently, understates the amount of the reserve. *The deficiency is represented by the present value of the excess of the valuation net premium over the gross annual premium.* In contrast to the regular policy reserves which increase with duration, deficiency reserves for a given class of policies decrease over time, *disappearing altogether at the end of the "premium-paying period"* (Emphasis added).